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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D. C. 20554

In the Matter of	)	
	)	
Price Cap Regulation of Local Exchange Carriers	)	CC Docket No. 93-179
	)	
Rate of Return Sharing And Lower Formula Adjustment	)	

COMMENTS OF THE NYNEX TELEPHONE COMPANIES

New York Telephone Company
and
New England Telephone and
Telegraph Company

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COMMENTS OF THE NYNEX TELEPHONE COMPANIES

New York Telephone Company ("NYT") and New England Telephone and Telegraph Company ("NET"), collectively the "NYNEX Telephone Companies" or "NTCs", hereby file their comments on the Commission's Notice of Proposed Rulemaking ("NPRM") in the above-referenced proceeding.[1]

I. INTRODUCTION AND SUMMARY

In the NPRM, the Commission proposed to clarify its rules concerning the method of calculating a local exchange carrier's ("LEC's") rate of return in implementing the sharing and lower formula adjustment ("LFA") backstop mechanisms of the price cap system. The NPRM addresses an issue that was raised

Commission's rules require a LEC to normalize its rate of return for a reporting period by "adding-back" any rate reduction due to sharing of over-earnings from the previous period or by removing any revenues associated with an LFA for underearnings in the previous period.

In the NPRM, the Commission noted that normalization was required under the rate of return enforcement mechanism that preceded price caps and that the Commission had not modified its rules for reporting rates of return. The Commission also found that add-back of sharing and LFA effects was a necessary component of the price cap backstop. To eliminate any ambiguity in the current rules, the Commission proposed to amend Section 61.3(e) of its rules to make it clear that base period earnings should not include revenues associated with exogenous adjustments for sharing or LFAs. Finally, the Commission requested comments on whether the LECs should be given a credit for below-cap rates in calculating an add-back.

The NTCs support the Commission's proposal to clarify its rules. The proposed clarification is fully consistent with other rules that currently require the LECs to normalize their rates of return in computing sharing and LFA amounts. The clarification is also consistent with the Price Cap system. Normalization is absolutely essential to enforce both the upper and the lower earnings limitations of the Price Cap system.

share only the amount of revenues necessary to ensure that they

AT&T v. FCC.[2] In that case, the court found that the automatic refund rules in 47 C.F.R. Section 65.700 et seq were inconsistent with the rate of return prescription that the rules were intended to enforce.[3] The automatic refund rule required the LECs to make refunds for years in which their earnings exceeded the prescribed rate of return, plus a buffer, while it provided no mechanism for the LECs to recoup shortfalls for years in which their earnings were below the prescribed rate of return. The court found that this produced a "systematic bias" that would depress carrier earnings below the prescribed rate of efficient.[5] To provide a balance of risk and reward, the Commission adopted the LFA mechanism, which allows the LECs to increase their price cap rates to the extent that their earnings in any given year are below 10.25 percent. Although this is 1 percentage point below the prescribed rate of return, the Commission found that it would not be confiscatory, because it would still allow most companies to continue to attract capital and to maintain service.[6] The Commission found that "a LEC with earnings below 10.25 percent is likely to be unable to raise the capital necessary to provide new services that its customers expect. It may even find it difficult to maintain existing levels of service."[7] Therefore, the Commission adopted the LFA mechanism to ensure that the LECs could earn the minimum necessary return. If the Commission applied the LFA in a way that would tend to drive earnings below the LFA level, the Commission would contradict its own rate of return findings in the same way that it did in <u>AT&T v. FCC</u>.

A failure to require normalization of a LEC's rate of return in computing sharing or LFA amounts would do exactly that. This is illustrated in Attachment A, which shows the

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5 <u>LEC Price Cap Order</u> at para. 123. The sharing mechanism also requires a LEC to share 50 percent of earnings between 12.25, percent up to a maximum of 16.25 percent, at which point the LEC would share 100 percent of earnings. This would prevent the carriers from earning more than 14.25 percent after making sharing adjustments. Id. at paras. 124-125. These limits assume that a LEC has

effect of using actual rates of return to compute sharing obligations and LFA amounts for LECs whose earnings are above [redacted]

17 percent in the first year would refund 100 percent of its earnings above 16.25 percent and 50 percent of its earnings between 12.25 percent and 16.25 percent, reducing its effective rate of return to 14.25 percent in the second year, all other things being equal. However, if the LEC used its actual rate of return in the second year, including the rate reduction for sharing, to compute its sharing obligation for the third year, it would only share 50 percent of earnings between 14.25 percent and 12.25 percent. Since it would also reverse the second year sharing amount, its earnings would increase to 16.0 percent. Put another way, the LEC would "get back" half of the revenues it shared in the second year through reduced sharing in the third year. This "see-saw" effect would produce average earnings that would converge to a level between 15.34% and 15.45%, well above the price cap upper earnings limit of 14.25 percent. In addition, this see-saw effect would prevent the LEC from sharing the correct amount even if its earnings were not above the cap.

The charts in Attachment A also demonstrate that the LECs would achieve the earnings levels intended by the Price Cap Rules if they normalized their rates of return. Normalization allows a LEC earning 8.0 percent to incorporate an LFA in each year's annual tariff filing that is sufficient

III. THE NPRM SIMPLY CLARIFIES THE FACT THAT THE COMMISSION'S RULES ALREADY REQUIRE NORMALIZATION OF RATES OF RETURN

The Commission's decision to clarify the normalization requirement in the NPRM does not imply that normalization is not required by the current rules. The NPRM simply makes explicit a rule that, as shown above, is implicit in the rules on earnings limitations. Thus, the Commission should find that normalization of rates of return is an existing obligation that applies to both the pending investigation of the 1993 Annual Access tariffs and to future tariff filings.

While some parts of the Commission's Price Cap rules are very explicit, such as where they provide formulas for computing changes to price cap indexes, other parts are descriptive in nature. The latter type of rule places the burden on the LEC to show that its tariffs are consistent with the words and intent of the rule. This is the case with respect to the rules governing most exogenous adjustments, including sharing and LFAs. For example, the rule requiring exogenous treatment of changes in the Separations Manual does not provide any instructions as to how to calculate the effect of separations changes.[9] Section 61.49(a) requires the LECs to submit sufficient data to support their tariff filings. Therefore, in calculating an exogenous cost adjustment for separations changes, the LEC must show that its methodology is rules and it must provide sources for its data. Similarly, the rules that require the LECs to make exogenous adjustments for sharing and LFA speak in general terms.[10] Therefore, a LEC must show that its method of calculating exogenous adjustments for sharing and LFAs is consistent with the Price Cap rules and with the intent of the orders implementing those rules.

As demonstrated in Section II above, it is impossible to compute the correct sharing or LFA amounts for the prospective period without normalizing the base period rate of return. Therefore, Part 61 of the Commission's rules requires the LECs to demonstrate the reasonableness of their tariff filings by normalizing their rates of return in computing sharing or LFA amounts.

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10 See 47 C.F.R. Sections 61.45(d)(1)(vii) (LECs may include adjustments "retargeting the PCI to the level specified by the Commission for carriers whose base year earnings are below the level of the lower adjustment mark"); 61.45(d)(2) (LECs must include adjustments "as may be necessary to reduce PCIs to give full effect to any sharing of base period earnings" required by the Commission's rules). There is some uncertainty concerning the exact wording of Section 61.45(d)(2). As adopted in

The NPRM correctly notes that when the Commission adopted its Price Cap rules, it did not modify the requirement that the LECs report earnings on their Form 492 rate of return reports using normalized revenues.[11] The instructions for the Form 492A Report state that reported revenues should reflect earned (i.e., normalized) revenues for the reporting period (Instruction F of the General Instructions). When the Commission established its rules for the earnings reports, it required the LECs to report earned revenues rather than unadjusted "booked" revenues so that revenues would relate to the appropriate period and so that they would be consistent with how expenses and other items are reported on Form 492.[12] When a LEC collects revenues for services that it has

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11 NPRM at paras. 8, 10, citing LEC Price Cap Order, para. 373. This issue was addressed indirectly in the LEC Price Cap Reconsideration Order (Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Order on Reconsideration, 6 FCC Rcd 2637 (1991)). In the Price Cap Proceeding, the United States Telephone Association ("USTA") pointed out the sawtooth effect in opposing AT&T's suggestion that the PCI adjustments to bring a LEC's earnings to the LFA mark should be one-year adjustments. USTA argued that the LFA should be permanent, to prevent the LEC from earning less than its cost of capital in the year that the LFA was reversed. See Opposition of USTA to Petitions for Reconsideration, CC Docket 87-313, filed December 21, 1990. The Commission responded by pointing out that "if a LEC continues to operate below the lower adjustment mark, the LEC will be subject to a subsequent PCI adjustment." Id. at n. 166. If the LFA is a one-year adjustment, the only way that the LEC could receive an LFA in the subsequent year, as the Commission intended, is if the LEC removed the LFA from its reported rate of return for the previous year.

12 See Amendment of Part 65, Interstate Rate of Return Prescription: Procedures and Methodologies to Establish Reporting Requirements, Report and Order, 1 FCC Rcd 952, 957 (1986).

provided in a prior period, (so-called "backbilling") it does not report the revenues for the period in which they are received, because the revenues were "earned" in the period during which the services were provided. Therefore, the LEC deducts those revenues from its booked revenues during the reporting period. Similarly, when a LEC gives a customer a credit or refund for overbillings in past periods, it normalizes its revenues in the reporting period by adding back the amount of the overbilling credit.

These principles are directly applicable to LFA and sharing amounts. An LFA is like backbilling, because the LEC receives the LFA revenues in the reporting period to compensate it for underearnings in the prior period. Thus, the LFA is "earned" in the past period, and it must be removed from revenues in the reporting period to reflect revenues earned during the reporting period. Sharing is like a credit or refund, because it is a reduction in revenues to return to ratepayers a portion of revenues that were overearned in the prior period. Those sharing revenues must be added back to the revenues in the reporting period to reflect revenues that would have been received in the reporting period absent the exogenous adjustment for sharing.

For these reasons, the Commission should confirm the fact that the rule changes it proposes in the NPRM would clarify the requirement of the existing rules, rather than modify those requirements. This would avoid creating confusion in the 1993 Annual Access Tariff Proceeding concerning the proper method of reporting earnings for the purpose of computing sharing and LFA amounts.

IV. THE COMMISSION SHOULD NOT ADOPT A CREDIT FOR BELOW-CAP RATES

The Commission questions whether a LEC that has set its rates below the price cap indexes during the base year should receive a credit for the amount between its PCI and its API, or actual prices, in calculating sharing amounts.[13] The rationale for this proposal is that it would reward LECs that "share" a portion of their revenues with ratepayers by maintaining below-cap rates.

As the Commission notes, it rejected a similar proposal in the LEC Price Cap Order because it would add administrative complexity to the price cap system, with no offsetting benefit.[14] It should also be made clear that this proposal has nothing to do with the issue of add-back. Regardless of whether credits are included in sharing and LFA amounts, the sharing and LFA revenues must be "added-back" to determine the normalized rate of return as a basis for further sharing or LFA in the next year. Thus, the credit proposal must be evaluated solely as a proposal to modify the price cap backstop mechanisms.

This proposal does nothing to improve the price cap system, and it adds administrative complexity and confusion by adjusting the PCI through reference to the API. A LEC whose

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13 NPRM at para. 16. The proposed "credit" mechanism also would reduce the LFA for an underearning LEC that voluntarily had maintained below-cap rates.

14 NPRM at para. 16, n.12, citing LEC Price Cap Order at paras. 18=38-39.

earnings were in the sharing zone but whose API was below the PCI would have already obtained the benefit of the "credit" by being required to share less revenue than if its API were at the PCI, because its rate of return was lower. If the LEC had increased its rates to bring its API to the PCI, it would have had to share an additional amount equal to at least half of the increase. Moreover, there are normally several rate changes throughout a year, making it difficult to determine the exact amount by which the API was below the PCI. Finally, a credit mechanism would be complicated because it would have to be adjusted for the reduction in demand, if any, that would have occurred if the LEC had raised its API to the PCI to determine the amount of the "sharing" that the LEC had already passed through to ratepayers by maintaining below-cap rates.

The Commission should not complicate the sharing and LFA formulas by incorporating a credit mechanism. Since a "credit" already applies through the mechanism of the price cap indices and the sharing formula, it is unnecessary to add another credit. The Commission adopted sharing and LFA as backstops on earnings, not prices. The current formulas, based on normalized rates of return, provide a reasonable and administratively feasible method of enforcing the earnings limitations that are the basis for the price cap system.

V. CONCLUSION

For the foregoing reasons, the Commission should clarify its rules to require the LECs to use normalized rates of return in computing sharing and LFA amounts, but without the credit mechanism proposed in the NPRM.

Respectfully submitted,

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MECHANICS OF FEDERAL PRICE CAPS
SHARING AND LOWER FORMULA ADJUSTMENT

Below are several simple examples that outline the two contending methods of calculating the sharing and lower formula adjustment mechanism (LFAM). For the sake of simplicity, we assume that calendar year and tariff year periods are identical. In addition, we also assume in each period realized productivity offset levels that will produce rates of return identical with the first period. The intent of these assumptions is to identify rate of return variations in each year purely as a product of sharing/LFAM exogenous adjustments.

1. Lower Formula Adjustment Mechanism based on earnings including previous LFAM adjustments.

	Gross ROR	LFAM	Adjustments	Net ROR
Base Year(1)	8.0	N/A	0	8.0
Year 2	8.0	10.25	+2.25	10.25
Year 3	10.25	10.25	-2.25	8.0
Year 4	8.0	10.25	+2.25	10.25
Year 5	10.25	10.25	-2.25	8.0
Year 6	8.0	10.25	+2.25	10.25
Year 7	10.25	10.25	-2.25	8.0

In this example, the LEC realizes base year (year 1) earnings of 8.0 percent. In year 2, the LEC is entitled to an exogenous adjustment of +2.25 percent in order to prospectively recoup the shortfall from the base year. If the underlying earnings in year 2 are the same as that in the base year (as assumed above), then the LEC earns 10.25 percent in year 2. In year 3, the LEC having earned 10.25 percent in year 2 is not entitled to an exogenous adjustment. However, if the exogenous adjustment from year 2 is treated as a temporary one, then it must be reversed in year 3. Assuming the underlying earnings in year 3 are the same as that of the base year and year 2, the LEC earns only 8.0 percent in year 3. In year 4, the LEC is once again entitled to an exogenous adjustment and earns 10.25 percent in that year.

The effect of this mechanism is a sawtooth pattern of earnings represented by the Net ROR column above. Specifically, an exogenous adjustment is implemented in year 2 increasing year 2 earnings, and reversed in year 3, reducing year 3 earnings. However, since the adjustment in year 2 is included in the evaluation of earnings for year 2 adjustments, no new adjustment is made in year 3. This depresses year 3 earnings triggering a year 4 adjustment.

Now consider an alternative view where exogenous adjustments are treated as temporary, but are based on prior year earnings not including exogenous adjustments.

2. Lower Formula Adjustment Mechanism based on base earnings excluding previous LFAM adjustments.

	Base ROR	Gross ROR	LFAM	Adjustments	Net ROR
Base Year(1)	8.0	8.0	N/A	0	8.0
Year 2	8.0	8.0	10.25	+2.25	10.25
Year 3	8.0	10.25	10.25	-2.25+2.25	10.25
Year 4	8.0	10.25	10.25	-2.25+2.25	10.25
Year 5	8.0	10.25	10.25	-2.25+2.25	10.25
Year 6	8.0	10.25	10.25	-2.25+2.25	10.25
Year 7	8.0	10.25	10.25	-2.25+2.25	10.25

In this example, the exogenous adjustments are temporary, but each year the underlying base ROR causes an upward exogenous adjustment to nullify the expiration and reversal of the prior year's adjustment. Consequently, the LEC will earn at the lower formula adjustment mark.

The analysis above can be applied to the sharing mechanism.

3. **Sharing mechanism based on earnings including previous sharing adjustments with no interest.**

	Gross ROR	Sharing Trigger	Adjustments	Net ROR
Base Year(1)	17.00	N/A	0	17.00
Year 2	17.00	>16.25 100% 12.25 50%	-2.75	14.25
Year 3	14.25	"	+2.75-1.0	16.00
Year 4	16.00	"	+1.0-1.875	15.125
Year 5	15.125	"	+1.875-1.438	15.562
Year 6	15.562	"	+1.438-1.656	15.344
Year 7	15.344	"	+1.656-1.547	15.453

The method used in this example matches that used in the lower formula adjustment mechanism in 1. above.

In this example, the LEC realizes base year (year 1) earnings of 17.00 percent. In year 2, the LEC is liable for an exogenous adjustment of 2.75 percent in order to prospectively return to the ratepayer 100% of the base year's earnings above 16.25%, and one half of the base year's earnings between 12.25% and 16.25%. If the underlying earnings in year 2 are the same as that in the base year (as assumed above), then the LEC earns 14.25 percent in year 2. In year 3, the LEC having earned 14.25 percent in year 2 is liable for another exogenous sharing adjustment, but this adjustment is smaller than might otherwise be expected since it is based on 14.25 percent earnings and not the underlying 17.00 percent. The exogenous adjustment from year 2 is reversed in year 3, and the LEC earns 16.0 percent. In year 4, the LEC is once again liable for an exogenous sharing adjustment and earns 15.125 percent in that year. This process continues through year 7. Notice that since the underlying earnings for each year are 17.00 percent, this method of computing exogenous sharing adjustments allows the LEC to retain more of its underlying earnings. That is, the ratepayer is entitled to 2.75 percent sharing each year, but never receives it, except in year 2.

Now consider the alternative view where exogenous adjustments are treated as temporary, but are based on prior year earnings *not including* exogenous adjustments. This matches the LFAM method in 2. above.

4. **Sharing mechanism based on earnings excluding previous sharing adjustments with no interest.**

	Base ROR	Gross ROR	Sharing Trigger	Adjustments	Net ROR
Base Year(1)	17.00	17.00	N/A	0	17.00
Year 2	17.00	17.00	>16.25 100% 12.25 50%	-2.75	14.25
Year 3	17.00	14.25	"	+2.75-2.75	14.25
Year 4	17.00	14.25	"	+2.75-2.75	14.25
Year 5	17.00	14.25	"	+2.75-2.75	14.25
Year 6	17.00	14.25	"	+2.75-2.75	14.25
Year 7	17.00	14.25	"	+2.75-2.75	14.25

In this last example, the exogenous adjustments are temporary, and each year analysis of the underlying rate of return of 17.00 percent causes a downward sharing adjustment to nullify the expiration and reversal of the prior year's adjustment. As a consequence, the LEC earns 14.25 percent. The ratepayer and the LEC receive each year their fair share of the earnings (with interest to compensate ratepayers for the time value of money). This appears more in line with the Commission's intent in the Price Cap and subsequent orders.

FORM 492A - SHARING AND LFA